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SUBJECT: IMF: 17% INFLATION THREATENS MONGOLIA'S ECONOMIC STABILITY

Ref: 07 Ulaanbaatar 0686

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11. (SBU) SUMMARY: According to the IMF Article IV Consultation mission that visited Ulaanbaatar last week, Mongolia's macroeconomic stability is threatened by rapidly rising inflation, measured at 17% in January and climbing. Prices are being pushed upward by increased government spending, rapid growth of money supply and credit, high international prices and the sinking value of the national currency. Government efforts to fight inflation have so far proven unsuccessful, and with Parliamentary elections set for late June, the GOM is unlikely to heed the IMF's advice to cut back on wage increases and welfare transfer programs. Meanwhile, the Central Bank is considering raising capital adequacy requirements of commercial banks to as high as 15% and doubling the minimum capital requirement to US\$13.7 million, to rein in lending and money creation. The de-facto pegging of the tugrik to the U.S. dollar has limited the Central Bank's ability to fight inflation in other areas. The local IMF office will close in 2009 due to IMF budget cuts. END SUMMARY.

IMF TEAM COMPLETES ARTICLE IV CONSULTATIONS

12. (U) Rapidly rising inflation is threatening Mongolia's macroeconomic stability, according to the IMF Article IV Consultation mission that concluded its visit on March 11. The IMF mission urged Mongolia to make reducing inflation its top priority.

INFLATION AT 17.5%; COULD REACH 20%

13. (SBU) Inflation reached 17.5% in January, up 2.4% from December 2007. IMF reps said price increases were due, among other factors, to large increases in government spending for civil-service wages and social-welfare outlays, especially in the final quarter of 2007; rapid growth in broad money supply and banking-system credit; soaring import prices, particularly for food and petroleum products; and transportation bottlenecks at the borders. Prices for food and nonalcoholic beverages, which rose 4%, were a major contributor to the CPI's overall increase. Some economists predict that the rate could top 20% before possibly cooling in the autumn.

GOM EFFORTS TO STABILIZE PRICES

14. (SBU) The GOM has worked to stabilize prices of main products such as food and fuel through subsidies and tax breaks, but to no avail. Despite continued subsidies and a stabilization agreement with Russia on fuel imports, petrol is expected to increase by US\$0.17 to US\$0.27 per liter from the current US\$1 at the pump, according to import companies. Vendors say GOM exemption on VAT for domestically produced meat is failing to make up for increasing fuel and transport prices.

GOM SPENDING ADDS TO INFLATION

15. (SBU) According to the IMF, increased government spending has aggravated inflationary pressures, and it urged the GOM to avoid further increases in civil-service employment wages or the introduction of any new spending programs. But few expect Mongolia's politicians to exercise fiscal discipline as the elections approach. In a meeting with the DCM and Econ/Coml Chief,

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IMF mission leader Roger Kronenberg said GOM officials seemed to take seriously the IMF's advice that proposed revisions to the 2008 budget -- calling for increased spending and a stimulus program providing Togruk 50,000 (US\$43) to every Mongolian -- could exacerbate inflationary pressures. But once the IMF team departed, the proposed stimulus plan of the ruling Mongolian People's Revolutionary Party was back on the agenda. So was a convoluted Democratic Party scheme that would deliver US\$1,000 to every Mongolian from mining profits.

BUDGET SURPLUS JUST TOO TEMPTING TO THE GOM

16. (SBU) Higher than expected revenues from high commodity prices and recent tax reforms (Mongolia now has some of the lowest income tax rates in Asia) have allowed the government to avoid a large deficit (beyond the GOM's traditional annual 3% deficit target), and Mongolia has experienced a budget surplus for three years running. Rather than desperately spend its way into deficit territory through mid-year budget revisions, the GOM was encouraged by the IMF to keep its eye on longer-term economic fundamentals. The IMF suggested that the GOM maintain a modest budget surplus in 2008, to prevent high inflationary expectations from becoming firmly entrenched.

MONEY SUPPLY GROWING TOO

17. (SBU) The IMF mission also recommended that the GOM slow the growth of money supply to bring inflation down quickly. According to the Bank of Mongolia, money supply has reached 2,337 billion Togruk (US\$2 billion), an increase of 50.2% over the past 12 months. Mongol Bank explained that money supply suddenly grew in the last month of the quarter, despite otherwise being lower. The increased supply of money has been due to government spending on social purposes, such as increased wages and pensions. In particular, there has been a dramatic increase in child allowances and allowances for newlywed couples. State employees were also given increased wages and salaries in the first and fourth quarter of 2007. Of the whole annual budget expenditure, 50.4%, or 881.9

billion Togrugs (US\$753 million), was distributed in the final quarter.

CREDIT EXPANDING

18. (SBU) The rapid growth of credit is also stoking inflationary fires. Loans issued by Mongolian banks grew 68% over the previous year. At a recent luncheon for the Mongolian Bankers Association, Central Bank Governor Batsukh casually floated the idea of raising the capital-adequacy requirement of commercial banks from 10% to 12%. Another Central Bank employee suggested it could be raised to 15% and then informed Econoff that the Bank was considering doubling the minimum capital requirement from 8 billion Togrugs (US\$6.8 million) to 16 billion Togrugs (US\$13.6 million). This tightening of banking regulation is expected to slow the rate of lending (and hence the growth of money) and perhaps weed out two or three of the sector's weaker banks, to provide greater stability.

EXCHANGE RATE ADJUSTMENTS LIMITED DUE TO PEG TO US\$

19. (SBU) The IMF mission also recommended reintroducing greater exchange-rate flexibility, in tandem with monetary policy, to help bring inflation down, facilitate adjustments to external shocks, and maintain external stability. The value of the Togrug has remained stable against the U.S. dollar at 1,170 Togrug/US\$1. Like the

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greenback, its value has been decreasing on international exchange markets, adding further pressure on imports. The IMF recently re-classified Mongolia's exchange-rate arrangement to a conventional peg, which acknowledges the de-facto peg of the Mongolian Togrug within margins of plus or minus 1% against the US dollar. This has limited the flexibility of the BOM's monetary policy in addressing inflation.

HARD TO ARGUE WITH ECONOMIC SUCCESS

10. (U) Mongolia's economic performance in recent years has been strong. Real GDP growth measured 9.9% in 2007. High copper and gold prices have strengthened the economy, as has strong investment in the mining and construction sectors. Public debt has been sharply reduced, and the Bank of Mongolia is posting a record level international reserves. Per-capita income has doubled since 2004.

LOCAL RESIDENT OFFICE A BUDGET CUT VICTIM - EVENTUALLY

11. (SBU) Kronenberg confirmed that the IMF's local resident office was being cut as part of the IMF's belt-tightening. The current IMF ResRep would stay in place and the office would remain open until his term expires in 2009. In other news, Kronenberg himself is retiring from the IMF. He noted that working on Mongolia for the past 12 years had been one of his "bright spots."
Minton